BH150-1

Financial Markets

Irving Trust

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Economic Research & Planning Division

Friday (Noon) Aug. 28, 1981

Sentiment in financial markets swung sharply this week--from despair right after the weekend to an emerging, tentative hope as the Federal funds rate traded down, on balance, during the week. The key source of uncertainty among market participants was whether the drop in the funds rate reflected an overt move by the Federal Reserve to make reserves more available to the banking system.

At this point the Fed does not appear to have been behind the rate drop, except very indirectly. The net borrowed reserves position of banks has moved up sharply in recent weeks, reflecting the impact of large increases in M-1B.

Statement Week Ending	Net Borrowed Reserves ($ bil.)	Cumulative Change of M-1B, Lagged Two Weeks ($ bil.)
8/5/81	0.7	0.0
8/12/81	1.0	+5.3
8/19/81	1.2	+6.1

This pattern suggests that, as one would expect under the Fed's reserves-oriented operating procedures, the bulge in the money stock is causing net borrowed reserves to increase as well. That should put upward pressure on the funds rate.

So what accounts for this week's softness? While a likely error by the Fed in projections of reserves availability probably played a role, it appears that the fundamental factor is the greater inclination of banks to borrow from the Fed's discount window. The reason is that large banks are allowed to borrow at the 14% basic discount rate in four weeks during a calendar quarter without having to pay the 4% surcharge. Since borrowings have been relatively modest thus far during this quarter, many banks presumably have all or a large part of their four "tickets" remaining to be used. As they attempt to use them before they expire at the end of September, the result is downward pressure on the funds rate. Something like this seems to have happened also during the first quarter of this year. Borrowings averaged $1.3 billion during the first half of the quarter (compared to $1.6 billion this quarter), and the funds rate declined sharply toward the end of the quarter. We have argued before that this system--which bears a striking resemblance to the use of time-outs late in a football game--could be improved upon. But the important point now for market participants is that, unless confirmed by increased reserves availability, funds rate declines produced in this fashion can easily be reversed--as indeed occurred after the end of the first quarter.

In view of the strength of the monetary aggregates relative to the Fed's presumed short-run targets, the outlook at this stage must be guarded.

William C. Melton

Note: The full text of this letter is available to Telerate subscribers on pages 7250-51 on the Monday morning following the Friday date of the letter.

	8/28/81 (Noon)	Week Ago	Year Ago
Prime Lending Rate at Irving Trust Company	20.50	20.50%	11.50
Effective since	7/8/81		
Discount Rate at Federal Reserve Bank	14.00	14.00	10.00
Federal Funds	16.25	17.50	11.00
Repurchase Agreements	15.00	17.00	10.75
U.S. Treasury Issues			
Bills			
3 months	16.15	16.20	10.36
6 months	16.94	16.90	10.74
1 year	16.60	16.60	10.50
Coupons			
2 years	16.54	16.20	11.65
4 years	16.10	15.72	11.80
7 years	15.53	15.18	11.90
10 years	15.23	14.86	11.90
Long Bond	14.44	14.09	11.50
Negotiable Certificates of Deposit-Secondary Market			
1 month	17.45	18.00	11.05
3 months	17.70	17.95	11.60
6 months	18.00	18.10	12.00
1 year	17.50	17.35	12.20
Banker's Acceptances			
1 month	17.70	17.85	11.05
3 months	17.75	17.95	11.45
6 months	18.10	18.00	11.60
Eurodollar Deposits			
1 month	18.25	18.38	11.25
2 months	18.50	18.63	11.50
3 months	18.75	18.63	12.25
Commercial Paper - Prime Names			
Directly placed by:			
Finance Companies			
1 week	15.00	17.00	10.75
1 month	17.25	17.50	10.63
3 months	17.00	17.00	10.50
Bank Holding Companies			
1 month	17.25	17.25	10.25
Dealer Placed:			
3 months	17.13	17.25	10.50
New AA Corporate Utility Bond	17.30	17.00	13.13
Tax Exempt			
6 month Project Notes	9.00	8.50	6.60
1 year AAA Bond	9.00	9.30	5.75
5 year AAA Bond	9.60	10.00	6.30
20 year AAA Bond	12.10	12.00	8.20

This information represents prevailing market yields.
It should not be construed as an offering.
All yields are on the offered side of the market.

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